Institute for Family Business

# Department for Business, Energy and Industrial Strategy Consultation
# Corporate Governance Reform
# Institute for Family Business Response

## 1. Executive Summary

- A long term outlook is at the heart of family business. Shareholders in family businesses view their role as stewards.
- Most family businesses are privately owned and do not have large numbers of disparate and institutional shareholders
- Family businesses use a variety of different means to stimulate genuine employee engagement, which goes well beyond the options set out in the paper
- We have serious concerns about the potential unintended consequences of designating non-executive directors as representatives for specific groups of stakeholders
- Culture within business is a key component in how a business, and its employees, behave responsibility
- High profile private business failings do not reflect the reality of how most family businesses operate
- The Government should focus any reforms or interventions on actions which will improve culture and embed genuine engagement and good governance in all businesses, rather than introducing additional burdens without preventing future failings.

## 2. About Family Business

**The Institute for Family Business**

2.1 The Institute for Family Business (IFB) is a not for profit organisation, supporting and promoting the UK family-owned business sector through events, networking, representation, thought leadership and analysis.

2.2 We work closely with family firms to support them in growing enterprises for generations to come. A central part of our work is to provide educational resources and events designed to support business owners and those who work in family business. We aim to champion best practice within the family business community and help others to learn from these examples.

2.3 Family business is the backbone of our economy, and the bedrock of our communities. In the UK, family firms generate a quarter of GDP and employ over twelve million people. By their very nature, family businesses take a long term view, build on long-term stewardship of people and resources. Their commitment to passing something on to the next generation is locked into their corporate DNA.

2.4 The family business sector is extremely diverse. Family businesses come in all sizes, are found in all industries and across the whole country. Whilst the majority of family firms are small or micro businesses, there are over 16,000 medium sized firms. Many of the largest private businesses referred to in the Green Paper are family owned businesses.

**The Nature of Family Business**

2.5 A long term outlook is at the heart of family business. Shareholders in family businesses view their role as that of a steward, with an obligation to pass the business on to the next generation in a stronger state than they found it. They feel a sense of responsibility not only to future generations of their own family, but also to the legacy of their forebears, their employees, and the community in which they are based.

2.6 Most family businesses are privately owned and do not have large numbers of disparate and institutional shareholders. On the contrary, shareholders tend to have a close relationship with the family business and play an important role in shaping the culture and values in the business. **Family businesses have an in-built natural tendency to approaching corporate stewardship in ways that ensure that the pursuit of good financial performance supports their long term objectives and values, rather than harming them.**

2.7 Whilst family businesses generate a quarter of UK GDP[1], they recognise that success in business is about more than short term financial results. Success is about sustainable value creation. Family businesses perform better than non-family firms in non-financial metrics such as investing in their employees and in supporting communities.[2] And the best-run family businesses outlast others by a factor of two.[3]

2.8 Family business leaders are frequently found as prominent members of local business groups, industry bodies, school boards and charities. They understand they are part of a wider community, and see value in working to raise standards across the whole community.

2.9 The family firm often represents not only a key part of a family's monetary wealth, but their heritage. This is a source of great pride, but also a source of responsibility. Family business owners understand better than any the importance of reputation, how long it takes to build, and how quickly it can be lost. When your name is above the door, responsible behaviour becomes part of the commitment to future generations of your own family.

2.10 To protect and build on this family owners are generally much more involved in the business than the typical investor. They understand the important role, and responsibilities, of being a governing owning. Successful families work to ensure that their shareholders' motivations and values are aligned, and that they act as responsible owners. But they also understand the importance of embedding these values, and this long term outlook, in the whole business.

2.11 **Families care about having a business which is well governed, to ensure that it is viable and sustainable in the long term.** Because they intend to own the business for the long term, rather than expecting to sell their stake within a few years, they also understand that good corporate governance

[1] Oxford Economics and IFB Research Foundation (2016) *The State of the Nation: The UK Family Business Sector 2015/16*
[2] M Institute and IFB Research Foundation (2012) *Sustainable Value Creation*
[3] Miller, D and Le Breton-Miller, I. (2005) *Managing for the Long Run: Lessons in Competitive Advantage From Great Family Businesses*

is in their own best interests, as their own family's future would be significantly affected were they to ignore corporate governance and allow a short term focus.

## 3. Executive Pay

3.1 Shareholders in family businesses have an attachment to their business which goes beyond financial considerations, and many businesses work hard to educate, engage and inspire shareholders. In this regard we believe that family businesses can provide best practice examples to listed companies of ways to improve investor relations, and inspiring a relationship less driven by short term financial results but genuine long term value creation.

3.2 Given the more disconnected relationship between shareholders and listed companies, we understand the reasons behind the introduction of shareholder voting on executive pay in this scenario. Questions 1 and 2 ask whether this regime should be extended. We believe that Government should focus any further measures on those companies that continue to make payments which their shareholders do not believe reflect company performance, rather than those companies genuinely listening to their shareholders.

3.3 Regarding the roles of remunerations committees and the introduction of pay ratios, discussed in Questions 3 and 4, we are concerned about the workability of these proposals. We are concerned about the impact on the supply of qualified remuneration committee chairs if a requirement for a minimum period of service before taking up the role of chair was introduced**. On pay ratios, we agree with the paper that these can lead to misleading comparisons,** particularly cross-sectoral comparisons, misunderstandings and unintended consequences of offshoring and outsourcing. Pay ratios, in the form of CEO pay in relation to median employee pay, also do not take into account the larger investment that companies make in their employees in terms of first class training and skills development, or the many other benefits companies offer to staff.

## 4. Strengthening the Employee, Customer and Wider Stakeholder Voice

4.1 Strong values and a vibrant company culture are found in family businesses, regardless of their size or sector, and this includes how they communicate with stakeholders. "Many family businesses have a distinct caring instinct which is extended to non-family staff members. This approach to valuing staff means that they go beyond regarding people as merely employees"[4]. Family businesses excel at embedding a culture of genuine engagement at all levels of their company.

4.2 There are many examples of how companies engage staff in the family business community. **Family businesses pride themselves on creating an atmosphere in which family owners know their staff, and are involved in the pastoral care of employees.** Family businesses will often have multiple generations of other families working within them, building strong bonds with their employees.

[4] Tomorrow's Company and IFB Research Foundation (2011) *Family Business Stewardship*

4.3 Employees in owner-managed family businesses are more likely to regard their managers as good at responding to suggestions and allowing them to influence final decisions, than in non-family owned businesses[5]. Employees in family businesses are also more likely to report that their manager can be relied on to keep promises and treat them fairly[6].

**Genuine Employee Engagement in Family Businesses**

Family businesses use a variety of different means to stimulate genuine employee engagement. These include roadshows, town hall meetings, open door policies, online hubs, newsletters, and more. Members report that family members often play an important role in communicating with and engaging stakeholders. They regularly meet suppliers and customers, and have a close connection to staff even in the very largest businesses. They join the executive team at employee meetings to share the family's values, and their vision for the long term success of the business.

One large family business spoke about the two year outreach programme they undertook after the family updated the company values. During this representatives of the family and senior management team met all staff, in groups of no more than two dozen employees, to not only share what the new values meant for the long term vision of the company, but used this as an opportunity to speak more broadly about the changing business environment and to stimulate a conversation with the employees about their experiences of the business.

Members have also spoken to us about the important role that technology plays in ensuring they can maintain regular engagement with employees, particularly as the business grows and the workforce becomes more spread across the country. One member spoke of their bi-annual virtual town hall meetings, where staff submit questions ahead of time and log on to a presentation and Q&A session by senior management. Multiple meetings are held during the day to ensure staff have as many opportunities to engage as possible. The recordings, answers and feedback requests are then shared with all staff so everyone was able to be involved in the process.

4.4 Given the amount and diversity of good practice in stakeholder engagement that goes well beyond the examples set out in the paper, we believe that the Government should focus action on spreading information and best practice. **Whilst the options provided in the paper may work for some companies, adopting these options exclusively risks undermining and stifling much of the active engagement which has developed organically over many years.** Companies, who have existing relationships with their staff and other shareholders, are in the best position to design a form of engagement that works best for their own unique situation.

4.5 Genuine engagement requires cultural, rather than regulatory, change. If companies simply pay lip service to stakeholder engagement for compliance reasons there is a risk of disenfranchising staff and further undermining trust in business.

4.6 The majority of companies understand the importance of engaged staff. Employees who feel valued and heard are vital for any business looking for long term growth, and responsible owners and managers understand that. Imposing a narrow range of options for employee engagement may give

[5] Bacon, N, Hoque, K and Siebert S (2013) *Family Business People Capital*
[6] Bacon, N, Hoque, K and Siebert S (2013) *Family Business People Capital*

the impression of raising the standards of the laggards, but this will likely lead to 'box ticking' compliance where companies focus on being seen to do that right thing, rather than actually engaging.

4.7 We do not support the proposal to designate non-executive directors as representatives for specific groups, and have serious concerns about the potential unintended consequences of this. Company directors have a Section 172 requirement to consider all stakeholders, and the impact their actions would have on these. We are concerned that this proposal risks undermining this duty by creating a culture which sees directors abdicating responsibilities for stakeholders outside their designated interest group. In practice this could reduce the voice of certain stakeholders in the board room, as consideration of their interests becomes reliant on an individual director rather than the whole board.

4.8 If the Government is concerned that there are cases of directors failing to fulfil their Section 172 duty to all stakeholders, **the most effective way to address this would be through training**. The Government should promote best practice in this area, which would include induction of new directors and regular training to ensure they are able to perform their duties to the highest standard.

## 5. Corporate Governance in Large Privately-Held Businesses

5.1 The majority of UK family businesses are privately-held. In this section we address the questions put forward in the green paper, but also seek to provide a better understanding of how the majority of private family businesses operate as responsible corporate citizens.

5.2 Culture within business is a key component in how a business, and its employees, behave responsibility. In family business this culture often originates from the family's values, and should then be reflected in the work of the Board. Where failings have arisen in other businesses, this has often originated in the culture and values of the business and its investors.

5.3 **Good governance within successful family businesses has two components – family and corporate governance.** Corporate governance covers the direction of the business operations, while family governance covers the frameworks and rules that define family members' roles and responsibilities, and how they interact with the business.

**Responsible Ownership**

5.4 Successful family businesses view their family governance as something which must continue to be reviewed and updated as the business, and family, grows. Introducing the next generation to the principles around good family and corporate governance often starts at a very early age, learning values from grandparents and parents.

5.5 Family governance and procedures will vary depending on the specific characteristics of each individual family business, but there are common structures. These have developed naturally as families look at how to ensure their business continues to take a long term approach to investment, and plays a wider role in society. **It is essential that families have the flexibility to introduce these**

**structures as best suits the unique requirements of their family and business, to best meet the needs of their employees and community.**

5.6 Some families establish written policies, or constitutions, to define their roles and responsibilities as family members and shareholders and to establish rules around family members working in the business, succession and share ownership. Larger families, particularly those with a greater number of shareholders, may establish a family council or assembly to help a family find consensus, act as guardians of the family' values, to maintain a strong shared long term vision and to communicate effectively with the Board.

5.7 We see many examples of family businesses who view discussions of shared sense of purpose as a central component of their family governance, to ensure the family agree about why they are in business together. This has a direct and unique impact on their attitude to share ownership, reinforcing their sense of stewardship and attachment to the business.

5.8 It is essential that families have the flexibility to introduce these structures as best suits the unique requirements of their family and business, to best meet the needs of their employees and community.

**Why Businesses Stay Private**

Most family businesses are privately-held, including some of the most successful and largest businesses in the UK. There are many reasons that these businesses remain private, and private business is an important part of a diverse business community. Listing should not be seen as an inevitable route for every business, and it isn't appropriate or desirable for many.

For many families the decision to keep the business private is based on a desire to ensure that it is able to maintain a long term multigenerational outlook, with a smaller group of shareholders who are committed to long term, sustainable and responsible growth.

Keeping a business private allows for longer term planning, rather than a short term focus on quarterly reporting. Taking a business public can risk the introduction of shareholders who are more interested in short term results than genuine, long term, sustainable growth.

For family businesses, where there is a strong personal connection, there are also considerations about introducing shareholders who do not share the same core values.

**Corporate Governance in Large Family Businesses**

5.9 There are many examples of governance best practice within the family business community. And family owners often feel a greater, and more personal, need to ensure that strong values are upheld throughout their business because their own name is above the door. High profile failings and behaviours are not reflective of how the overwhelming majority of private family businesses operate.

5.10 **Large family businesses already have strong corporate governance frameworks**, including effective boards, which meet regularly and include non-executive directors. Most family businesses hold themselves to the highest standards of corporate governance best practice from around the world. They do this in a way which is most appropriate to their own unique circumstances – circumstances which can vary significantly even within the family business community, let alone the wider private business environment. Some choose to adopt those parts of the FRC or other codes which are appropriate to their business.

5.11 Large private family businesses are also already subject to laws which protect shareholders and other stakeholders, and where directors behaviour lead to company failures they do already have a means of redress.

5.12 Families care about having a business which is governed in a way that will make it viable and sustainable in the long term. Families have no intention to exit the business. They understand that corporate governance failures would not only affect their employees and communities, but also the future of their own family.

**The Importance of Culture**

5.13 It is because of this combination of strong values, a long term outlook, an engaged shareholder base, and the existing legal routes available that we do not believe that a code, such as the FRC code, is required for large family businesses. **Nor do we believe that it is a suitable way of addressing the concerns about private business behaviour which the Government has put forward**, which are predominantly failings within individual business cultures.

5.14 Instead the Government should take an approach which seeks to highlight the principles for best practice within private business, to support understanding of the business benefits which good corporate governance bring, and to influence a change in the culture of businesses which prioritise short term gain over long term growth which supports owners, employees and their communities.

5.15 **We, therefore, believe that an approach which promotes best practice through a set of principles for good governance is a suitable and proportionate approach for large UK family businesses.** We welcome the opportunity to work with the Government to establish such a set of principles, to ensure they take into account the unique characteristics of family businesses and these principles create an upward spiral of raising governance and creating a culture of responsible ownership in all businesses.

5.16 This approach could also lead to cultural change within listed companies, by spreading awareness of the benefits of taking a long term approach, it could lead to benefits far beyond those of a code.

5.17 **We believe that this principles based approach is more appropriate to a diverse private business community, which is not suited to one size fits all approach.** The private business community is extremely diverse. Companies owned by private equity investors have very different behaviours, cultures and criteria for success, compared to multi-generational family businesses. In Table 7 the paper categorises founder and family owned businesses together. Whilst some founder owned businesses view themselves as 'first generation family businesses' and take a long term outlook, others are more focused on short term results and preparing for sale. This drives very different behaviours. It is incorrect to view private businesses as a single group with one set of behaviours within the context of this paper.

**Supporting Sustainable Growth**

5.18 Were a PLC-type corporate governance code extended to private family businesses, we are concerned about the impact this would have on growth and investment. When codes are introduced the focus of the Board shifts from discussions of innovation and growth, to a primary focus on compliance and populating the Board with compliance experts. Businesses become increasingly risk averse, stifling innovation and growth.

5.19 Given that the majority of companies are already behaving in a responsible manner, **we do not believe that the risks involved with introducing a code with a significant compliance component, the associated burden on business, and the consequent focus away from investment and growth, is proportionate or desirable.**

5.20 Question thirteen asks about application of non-financial reporting requirements, and whether these should in future be applied on the basis of size rather than legal form. **We do not support a blanket extension of all requirements**, but recognise that it may be appropriate and desirable for some of these reporting requirements to also apply to larger private businesses. The Government should consult on this on a case by case basis, and extend reporting where the benefits of doing so can be shown to outweigh the additional burden this would create for business.

5.21 Family businesses are ambitious to grow, to support strong communities and explore new opportunities. To ensure they are able to meet these ambitions it is essential the regulatory environment provides stability, giving them confidence to plan for the future. In the wake of the EU referendum business is undergoing a period of unprecedented uncertainty. Stability is important in giving businesses confidence to make investments decisions which will deliver growth for the long term.

**Principles for Good Governance**

5.22 There are many examples of governance best practice within the family business community. While failings in large private businesses are high profile they are rare, and expose wider cultural failings within those businesses.

5.23 **An approach which promotes best practice and cultural change, through a set of principles for good governance, is the most suitable and proportionate approach for large UK family businesses.** We are committed to working with the Government to establish such a set of principles, and further consultation is needed on this. However these principles should include, amongst other areas, the following:

- Shareholders should establish a governance framework. In family firms this should include family and corporate governance, and should clearly identify the roles and responsibilities of shareholders, board members, and managers.
- Companies should ensure their Board operates effectively. This should include directors with a mix of skills, who receive training on their responsibilities regularly, as well as performance monitoring.

- Companies should establish a process to ensure effective communication between the Board and shareholders.

## 6. Conclusion

6.1 When things go wrong in business the failings may be high profile but they, and the behaviours which accompany them, do not reflect the reality of how the overwhelming majority of private businesses operate.

6.2 We do not pretend that all private businesses always get things right, or that there is no room for any improvement in the corporate governance of any private family firm. But it is important to recognise there are many examples of governance and engagement best practice within the family business community.

6.3 The Government should focus any reforms or interventions on actions which will improve culture and embed genuine engagement and good governance in all businesses. This includes spreading the principles of good governance in private business, and in sharing and promoting examples of best practice.

6.4 It also includes championing the strengths of private family businesses – including engaged shareholders, a sense of stewardship and long term outlook – and challenging listed companies to implement learnings from these into their own business culture.

6.5 This approach would be proportional, given that most companies behave responsibly already, and address issues which would help to prevent future failings.

6.6 The Government must also avoid damaging the ability of private businesses to grow and invest, whilst recognising that UK businesses are currently operating in an environment in which business is looking to provide stability and reassurance.

6.7 Given that the majority of companies already behave in a responsible manner we believe that introducing a PLC-type code for private businesses is not a proportionate approach, and carries with it the possibility of a number of unfavourable unintended consequences.

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